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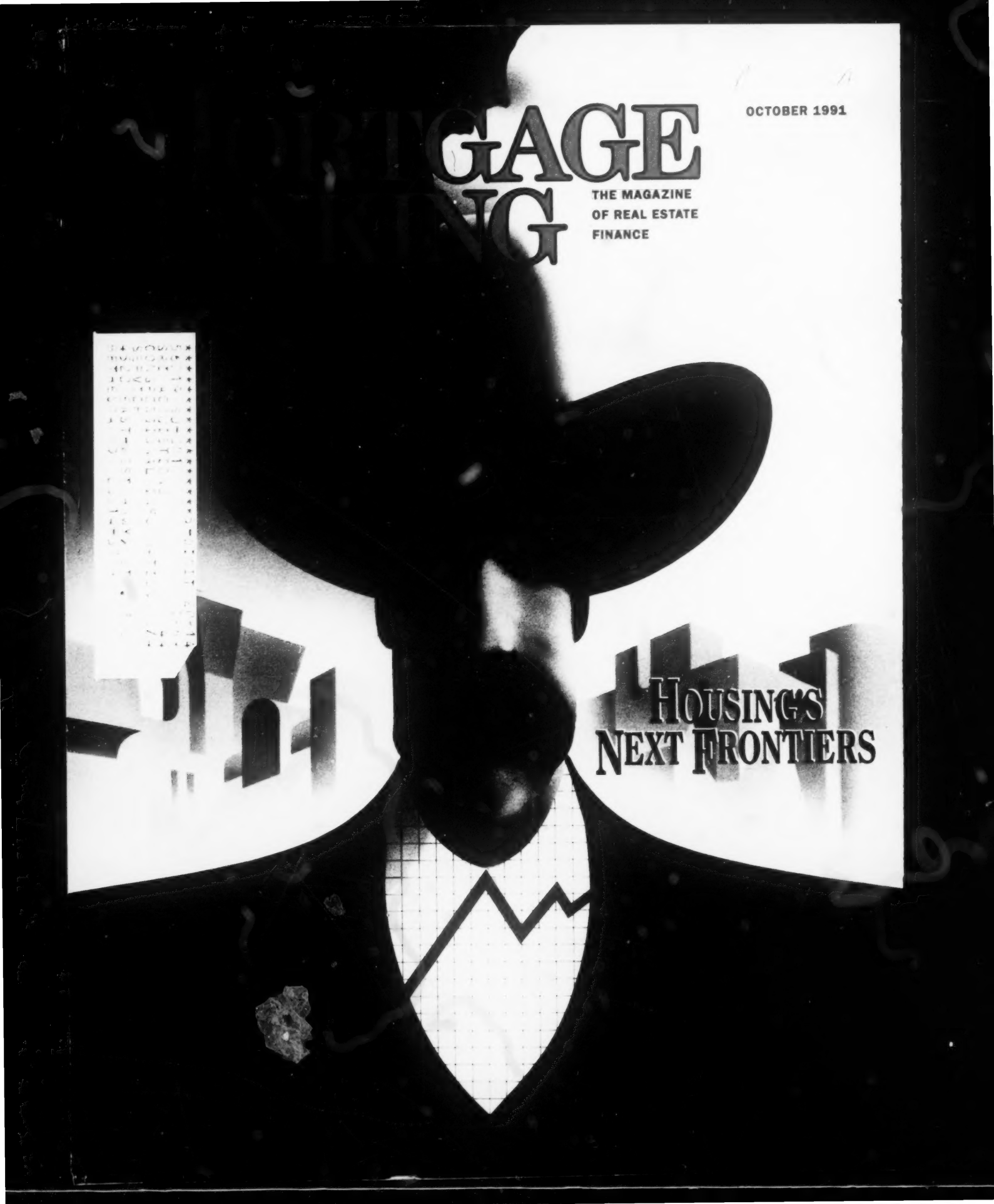

HOUSING'S NEXT FRONTIERS

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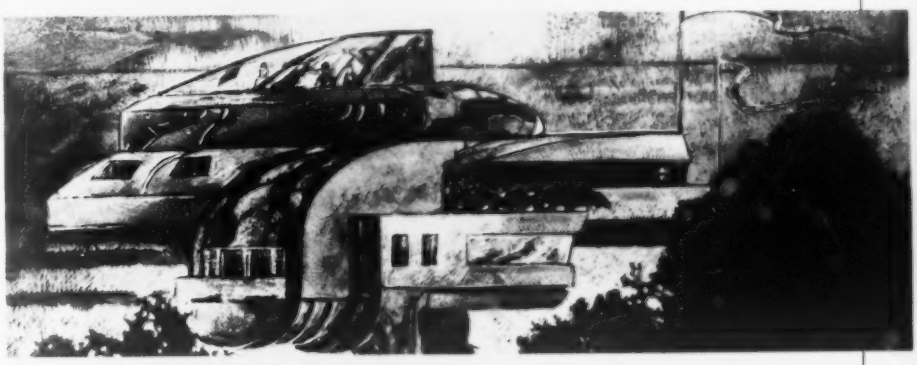

COVER:
Housing's Next Frontiers

"The farthermost limits of knowledge or achievement in a particular subject." That's how one dictionary defines frontier. This issue is an attempt to stake out some of those outermost reaches of knowledge in the field of housing. We tackled housing policy, mortgage product design and what the tea leaves are suggesting about tomorrow's hot regional markets. Altogether, we hope it provides a tiny glimpse at housing's future.

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Exploring New Territory

Housing policy has come a long way since 1862. But unfortunately while it's gotten more complex it's also gotten arguably less effective. Granted, it would be hard for HUD to compete with a policy that basically said find a piece of land in the public domain, live on it and work it, and BING—it's yours. That was the Homestead Act—back when federal policymakers really knew how to make policy. Call it a giveaway program, the quintessential sweat equity program or the ultimate affordability program. Call it what you want, it worked.

Unfortunately, the government has no vast unsettled acreage to give away any more. And today, finding policy solutions that open up homeownership to working Americans of very modest means is a much more formidable challenge. Unfortunately, we live in a world where decades of housing appreciation have outpaced wage inflation and tradeup buyers with wallets full of equity money have spiked housing prices through the roof. The open door policy of easy access to homeownership is the stuff of a bygone era.

Now, it's time for tackling the next frontier—the financial markets equivalent of a new Homestead Act. But how and with what—our government is no longer a land-rich, benevolent, emerging industrial power—it's in hock up to its elbows borrowing from foreign investors by the billions to pay the bills. Land is not free and money costs a lot of money.

This is where the challenge comes in for the engineers of mortgage credit. Like the early policymakers you have to look at what the need is and what the supply is, and then find a way to bring the two together. Like the vast acres of unsettled prairie land in the 1860s, today we can tap the world's capital for mortgage credit and it remains in ample supply—thanks largely to Fannie Mae and Freddie Mac and GNMA. But the incomes and the cash down payments and affordably priced housing stock clearly are in short supply. So, the industry must explore new and untraditional mortgage products and underwriting rules to get working people with stable jobs and solid credit into homes.

That is just one of the frontiers being explored today by some modern-day pioneers in this industry. We hope this issue will offer other insights into the ways housing can be made possible for a deeper cross section of American society. The days of direct giveaway programs are clearly over, but in other ways, housing's frontiers are still wide open.

Janet Reilley Hewitt
Editor in Chief

COMING IN NOVEMBER

In November, the topic is marketing and what keeps the customers coming back. We will look at Countrywide's quality service survey, see how one bank promotes a service culture and talk to Freddie Mac's top marketing person.

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Advertising (202) 861-6555
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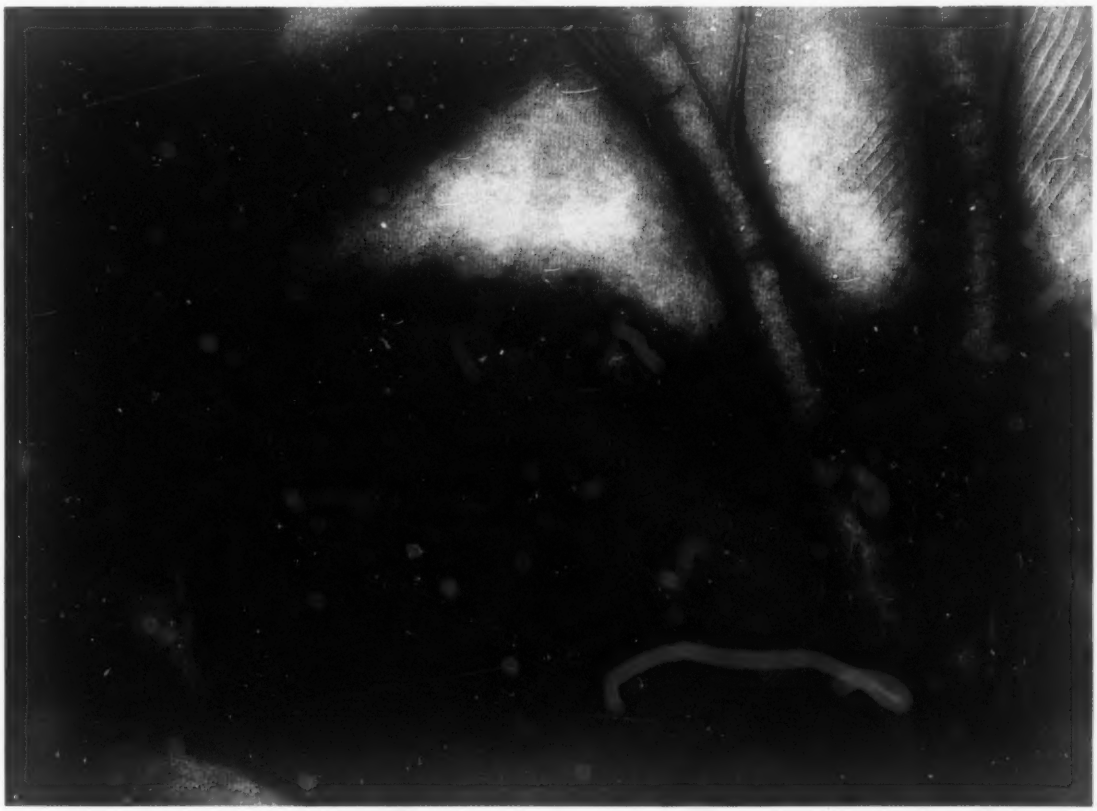
SCOUTING OUT NEW MARKETS



Regional housing markets have undergone recessionary strains that have recast the fundamental makeup of many. New opportunities are out there, but they are sometimes hidden—and blazing a trail to find the most profitable markets takes well-grounded facts and expert guidance.

Robert Hopkins

ILLUSTRATION BY LINA CHESAS

As the nation slowly pulls out of the recession that began in the summer of 1990, mortgage lenders, real estate agents, builders and homeowners anxiously await recovery in their local housing markets. Evidence is already accumulating that the market for new and existing housing bottomed early this year, at the beginning of the new building season, and has been slowly, though unevenly, improving ever since.

But, recovery in a national sense may not lead to an evenly distributed recovery in all parts of the country or in all facets of the housing market. This is especially true because this particular economic recovery is expected to be modest and slow. A very robust recovery would tend to boost most markets, as happened during the 1980s. But a modest recovery—especially one at the beginning of what will turn out to be a slow housing decade—will leave some areas without much improvement at all. "Competition" for recovery among regions or sectors may prove a dominant theme during the next few years. Thus, even among those who believe the economy is on its way back and will not retrench with a double dip, there is uncertainty about how individual regions will fare.

It is hazardous enough to try to predict the national economic future during cyclical changes. But on a local level, given the limited availability and poor quality of economic data, it is sometimes difficult to even understand the past. Nevertheless, it is the local, not national, recovery that generally affects small builders, Realtors, mortgage bankers and individual homeowners. As a result, regional analysts are constantly being asked to speculate on trends in individual areas. This article will present some issues relating to relative local housing performance, show some historical data and offer some limited expectations for future recovery.

To understand how a local housing market can deviate from national trends, we need to look at several different aspects of housing supply and demand. Changes in the national economy affect various regions differently depending on the local economic forces that prevail. In addition, every region of the country entered this recession with a slightly different history, particularly regarding how each region fared during the so-called "rolling" recession during the 1980s. Individual regions will react to the housing market differently, because of fundamental changes in general housing characteristics including how it is financed. Finally, as a part of the overall real estate sector, housing is not immune to the problems facing commercial real estate. The crisis in commercial real estate has, and will continue to have, regional implications that, to some extent, will cross over to the housing market.

Recovery in a national sense may not lead to an evenly distributed recovery in all parts of the country or in all facets of the housing market.

Local economic forces

First and foremost among differences in local housing markets is the overall health and status of the local economy in the current environment. Strong employment growth, low unemployment rates and rising incomes will lead to a strong real estate market. The converse is true for cities that are lagging in these factors.

Local economies are fundamentally driven by the fortunes of the types of industries that are located there. For example, the "Massachusetts miracle" of the mid-1980s was largely the result of the strong national demand for electronics, mini-computers and defense products that were designed or made in that state. When those industries grew strongly, decades of job losses and out-migration were reversed in the state. The economy was also helped by the rise in financial services, which mainly benefited New York City and Los Angeles, but also expanded the financial center in Boston. From this national base of demand for Massachusetts products and services, the local economy grew healthy and wealthy. Housing values soared and construction and rehabilitation expanded into New Hampshire and Rhode Island.

By 1987, it became increasingly clear that the growing demand was for computers in smaller and cheaper boxes than the ones made in the high-tech ring around Boston. At the same time, the defense equipment business had peaked and financial services companies were rocked by the stock market crash. Massachusetts fell into a major recession that continues today with no obvious sign of ending soon. Housing prices have fallen significantly and construction has been reduced to a minimum. It is unlikely that the improvement in the national housing market that is evident already and is likely to continue during the next 12 months will pull New England housing out of its slump.

Long-term structural factors

Over the long term, the economic structure that is destiny in the short term will evolve. In fact, it was evolution from textile manufacturing to high technology that brought Boston to its boom status in the 1980s. It is extremely difficult to predict changes in the long-term structure of local economies, but some general comments can be made. It is likely that the long-term factors that have pulled the U.S. population to the South and to the West will continue throughout the rest of the 1990s. Thus, we can expect continued growth in the Southeast from North Carolina to Florida; in the Southwest from Texas to Nevada and on the West Coast. The attraction of the Sun Belt will necessitate significant housing construction in those areas for years to come. Some of the attraction has been diverted to the Northwest aided by the cyclical strength of the aircraft industry in Seattle. Other areas that were havens of escape to more "natural" surroundings during the 1970s may not experience such rejuvenation during the 1990s. Colorado has struggled

through the last half of the 1980s despite its great attractiveness and may continue to lag during the 1990s.

If the Sun Belt continues to "win," in the race for recovery, the older parts of the country in the Northeast and near the Great Lakes will "lose." This is especially true because of the likely slower growth in the overall number of households during the 1990s. With fewer new households, it is more likely that gains in one area will come from absolute declines in other areas.

The crisis in commercial real estate has, and will continue to have, regional implications that, to some extent, will cross over to the housing market.

On a micro scale, long-term trends will continue to favor the suburban areas. This is especially true of large suburban concentrations that effectively function as total communities, such as those in New Jersey, or in Riverside and San Bernardino counties in California. The aging of the baby boom has pushed more and more people into the time of their lives when their children are growing older. Similar to the 1950s, the suburban school district, now supplemented by the suburban office park, holds a strong attraction for these families. Meanwhile, the urban problems, highlighted by the spread of crack cocaine and homelessness, as well as greater awareness of crumbling public infrastructure, will hurt the appeal of the central cities, unless another financial services-type boom takes over.

Such considerations might appear outside the focus of this article, because the topic we set out to address is the regional view of the recovery from the current recession. Yet, it is easier to start construction or to buy a house in a market with long-term growth prospects than in one that is likely to have long-term troubles. Overbuilding has traditionally been a problem in the hot growth markets, such as those in Florida or Arizona. In the current environment, the financial crunch, combined with regulatory restrictions such as statwide infrastructure requirements in Florida, limit the short-run likelihood of overbuilding.

Status of the regional economic cycle

The rolling recession that occurred during the 1980s means that the nation entered the 1990-1991 national recession with a number of regions already in or on the way out of an earlier local recession. Whether or not an area has been hit by prior local recessions in recent times will continue to affect how that area fares during this national downturn.

The most extreme example is Houston. When oil prices stopped rising in 1982, the end of the real estate boom in Houston was evident. When global oil prices plummeted in 1986, Houston was thrown into a major depression. Since bottoming out in early 1987, however, the economy of Houston has slowly improved. This slow, steady recovery has helped Houston avoid job losses associated with the 1990 contraction. In fact, Houston was the leading metropolitan area in terms of job gains among all large metropolitan areas. The area produced 27,000 new jobs between June 1990 and June 1991. While 27,000 new jobs is a modest gain for a major city (Los Angeles was

TABLE 1

Single-Family Permit Issuance in 1991 by Metropolitan Statistical Area Compared to Peak 1985-89 and Trough 1980-83 Issuance (In Thousands)

Metropolitan Areas Ranked by absolute change from 1985-89 peak year	1991 Single-Family Permits	Rank Among 100 MSAs	Change From 1985–89 Peak Years				Change From 1980–82 Recession Trough Years	
			Number of Permits	Rank	% Change	Rank	Number of Permits	Rank
Top Ten								
Houston, TX	12.9	9	4.5	1	54	1	−6.2	100
Louisville, KY-IN	5.2	40	1.7	2	51	2	3.8	28
Las Vegas, NV	14.3	6	1.6	3	13	17	11.3	2
Indianapolis, IN	7.9	22	1.3	4	20	11	6.4	7
Milwaukee, WI	4.5	44	1	5	28	8	3.5	32
Columbus, OH	7.3	25	0.9	6	15	14	5.2	13
Portland, OR	6.4	31	0.9	7	15	13	4.3	25
Omaha, NE-IA	3	60	0.7	8	33	4	1.9	48
Greenville-Spartanburg, SC	3.6	50	0.6	9	22	10	2.1	46
Tulsa, OK	2.6	67	0.6	10	32	5	0.3	86
Bottom Ten								
Middlesex-Somerset-Hunterdon, NJ	2.7	63	−7.2	91	−73	97	0.6	79
San Diego, CA	9.1	19	−7.5	92	−45	72	5.4	12
Atlanta, GA	27.1	1	−8	93	−23	47	14.1	1
Monmouth-Ocean, NJ	3.5	52	−8.5	94	−71	94	−0.1	92
Tampa-St. Petersburg-Clearwater, FL	9.5	16	−8.6	95	−47	77	−0.9	96
Norfolk-Virginia Beach-Newport News, VA	6.8	27	−8.7	96	−56	84	3.1	37
Philadelphia, PA-NJ	11.6	11	−9.4	97	−45	71	5.7	10
Washington, DC-MD-VA	18.6	2	−13.1	98	−41	68	4.5	20
Los Angeles-Long Beach, CA	9.7	15	−14	99	−59	86	5.2	14
Riverside-San Bernardino, CA	17	3	−26.2	100	−61	89	8.6	4

adding 100,000 jobs a year before the recession), this increase shows dramatic improvement from 1986. Other oil-patch cities also are showing good relative performance.

A similar story holds true for the industrial Midwest. With the exception of the auto-industry hub cities, the industrial Midwest is performing relatively better during this recession than during prior downturns. The intense wringing out of manufacturing jobs in the early 1980s left many midwestern cities with little growth before 1987 or 1988. During this recession, manufacturing is suffering less than it normally does under similar conditions. Combined with the fact that much of the Midwest sat out the excesses of the 1980s, this relative lack of harm to manufacturing means that the current recession is hitting this region less than it might have under other circumstances. The Midwest has shown a history of not growing very fast even during good times. Also, for the size of the market, housing construction is limited. Thus, there will not be a boom in housing in that region such as one would expect in Florida, California or Nevada. Nevertheless, this housing recovery should prove better than normal in the Midwest. Unfortunately, the lingering automobile recession will hold back such auto-hub cities as Detroit, Toledo and Cleveland.

In contrast, the Northeast—from Boston to Washington—entered a financial services/high technology/defense recession two or three years ago (each city's recession started at different times) several years before the national recession began. Unfortunately, the independence of the Northeast recession will likely apply to the recovery as well. While many say the national economy has started to turn around, recovery in the Northeast is still in the future.

The national recession and the real estate crash may intrude on these independent economic cycles. For example, to return to the oil-patch example, part of the Houston late 1980s advantage was the relatively inexpensive office space available in that market. But with office rents falling everywhere, the relative advantage earlier enjoyed by Houston is now eroding. The Phoenix market enjoyed some benefits as a lower cost alternative to Los Angeles. Now that commercial rents are dropping in Los Angeles as well, this advantage has been diminished.

Changes in the structure of the housing market

One fundamental change in the housing market became apparent in the latter half of the 1980s. For example, the depression in the oil patch led to declines of a third or more in the value of houses in Houston. Then, drops of 20 percent or more were noted in New York City houses and co-ops. In New Hampshire, previous house prices now are no longer a guideline to current value. Whatever the reason for these declines—whether people hear about trends in these areas, read articles in *Barrons* or evaluate the long-term demographics of the baby-bust generation—the fundamental lesson is that a house may no longer be the best investment you can make. Houses are now homes, not high-yield investments. This means that the speculative demand for houses is gone, other than in some exceptional cases. Thus the investment demand for housing has been reduced. People used to view renting as throwing money away. But many homeowners, as a result of depreciation in some markets, have thrown an equal amount of money away recently. Others, in the past, bought houses because it was important to get on the bandwagon before they were left behind. Now, the bandwagon may not be moving at all, so getting on quickly is not a priority.

The fundamental lesson is that a house may no longer be the best investment you can make. Houses are now homes, not high-yield investments.

This is not to say that homeownership will decline in the next few years. Rather, certain housing markets that have been driven by speculation and expectations of rapidly rising prices will have to adjust. For example, consumers will evaluate moving to high-priced regions knowing that such a move may not yield spectacular capital gains down the road. This could hurt the extremely high-priced areas, such as San Francisco, Orange County, California or New York City. Also, while there will be continued demand for condominiums that cater to true needs, such as those of empty nesters who no longer wish to struggle with yard maintenance, the demand for ownership of purely apartment-like condominiums will diminish. Why buy a pure "apartment" when it is unlikely to increase in value and may even decrease? Such reluctance to buy at the bottom end of the market will depress trade-up activity and will hurt builders who have increasingly gravitated toward the luxury end of the market. The aging of the baby boom was supposed to have brought increasing demand for upscale housing. But for that demand to run its course, there needs to be a mechanism for baby boomers to sell their current homes and afford more expensive houses in the absence of the outlandish capital gains made in many regions during the 1980s.

Excesses

Each local market has a different history, ranging from prudent to excessive building, of commercial and residential real estate during the 1980s. The areas that are particularly susceptible to overbuilding will face a more difficult time during this recovery. Overbuilding will lead to a construction recession even if the local economy is already in a recovery. The local recession in Arizona—which never actually led to overall job losses, despite the preliminary employment reports to the contrary—was really a construction recession that is part of the normal overbuilding cycle in that area. The excessive number of planned housing developments around Phoenix, before 1988, still make it very difficult for a housing recovery to take hold in that region.

Local zoning requirements, environmental regulations or practical considerations, such as overcrowdedness or physical barriers, limit potential overbuilding in some areas. Construction in Seattle and coastal California has always been limited by all these factors. Thus, recovery does not await the absorption of excess inventory. While other considerations will limit the housing recovery in these areas, past overbuilding is not one of them.

In the current environment, the credit crunch is protecting every re-

gion from additional overbuilding. This may reduce regional variations in the future, but does not necessarily help the current environment.

Recent regional activity

As the modest and uneven recovery in the national housing market continues, the way that various regions have fared so far in the cycle provides a revealing view of how strong or weak the local housing markets are. Tables 1 and 2 demonstrate the leading and lagging housing markets by various measures.

While this unevenness and uncertainty continues, the housing recovery that has already begun will manifest itself only tentatively and unevenly across regional markets.

The data presented in these tables show the number of permits issued for housing construction in Metropolitan Statistical Areas (MSAs) in the country. These data are the most comprehensive measures of housing construction in local areas. Housing construction in the first seven months of 1991 (the latest available data) lagged behind construction in the same period in 1990 in most areas of the country. However, a reasonable comparison between the two years is complicated by the fact that the first half of 1990 was that year's better half (the national recession started in July 1990), whereas the first half of 1991 likely will prove to be the weaker half. To compensate for this difference, the reported permits in the first seven months of 1991 were annualized using the ratio of national activity to provide a reasonable proxy of total 1991 construction of 950,000 single-family and 275,000 multifamily units. While these annualized regional figures are not a forecast for 1991, they are a reasonable way of comparing reported activity so far with previous years' activity. The annualized 1991 figures were compared with 1990 as well as with the year that represented that market's peak in construction between 1985 and 1989. The 1991 figures were also compared with the depth of the early 1980s recession. The best and worst of each category are presented in the tables. The tables show a number of variations among cities during the recent recession and the recovery thus far.

Single-family housing

The Riverside-San Bernardino MSA in California has suffered the greatest loss in construction in the country. On an annualized basis, 1991 construction in these two Southern California counties is down by 26,200 units from the 1988 peak construction year (See Table 1). However, the drop is from extraordinary heights: Construction in the Riverside-San Bernardino MSA surpassed construction activity in all but four states in 1988—an extraordinary record. Even after suffering a drop of more than 60 percent from the peak and 25 percent during the past year, the absolute number of single-family permits issued in the area is surpassed by only two other MSAs—Atlanta and Washington, D.C. The relative strong performance of Riverside-San Bernardino in the limit-

TABLE 2

Multifamily Permit Issuance in 1991 by Metropolitan Statistical Area Compared to Peak 1985-89 and Trough 1980-83 Issuance (In Thousands)

Metropolitan Areas Ranked by absolute change from 1985-89 peak year	1991 Multi-Family Permits	Rank Among 100 MSAs	Change From 1985–89 Peak Years				Change From 1980–82 Recession Trough Years	
			Number of Permits	Rank	% Change	Rank	Number of Permits	Rank
Top Ten								
Honolulu, HI	5.1	10	3.0	1	144	2	3.8	3
Houston, TX	5.7	6	2.7	2	91	3	−12.0	100
Gary-Hammond, IN	2.8	25	2.2	3	374	1	2.5	11
Cincinnati, OH-KY-IN	4.0	16	0.2	4	4	4	2.8	8
Madison, WI	1.6	36	0.1	5	4	5	1.1	21
Lake County, IL	1.0	42	−0.3	6	−25	7	0.9	24
Wichita, KS	0.3	75	−0.4	7	−56	22	−1.0	79
Rochester, NY	0.4	72	−0.4	8	−53	19	0.1	44
Scranton-Wilkes-Barre, PA	0.2	81	−0.5	9	−68	38	−0.2	57
Bridgeport-Milford, CT	0.4	69	−0.6	10	−61	29	−0.1	53
Bottom Ten								
Chicago, IL	3.9	17	−12.0	91	−75	54	−0.3	62
New York, NY	5.8	4	−13.9	92	−71	41	−0.4	64
Tampa-St. Petersburg-Clearwater, FL	4.6	12	−14.2	93	−75	55	−2.7	92
Fort Worth-Arlington, TX	0.1	89	−14.3	94	−99	97	−4.6	97
Atlanta, GA	1.4	37	−17.1	95	−93	82	−4.6	96
Riverside-San Bernardino, CA	4.3	15	−20.3	96	−83	61	1.9	13
San Diego, CA	4.4	13	−23.1	97	−84	64	0.7	27
Dallas, TX	3.0	22	−25.0	98	−89	75	−7.4	98
Phoenix, AZ	0.5	56	−27.2	99	−98	94	−9.9	99
Los Angeles-Long Beach, CA	13.1	1	−40.5	100	−76	56	3.2	4

ed housing market of 1991 is an encouraging sign for the market as a whole, but the extent of the decline suggests that full recovery in today or tomorrow's environment is unlikely.

Riverside-San Bernardino, Los Angeles and San Diego, which rank among the 10 MSAs with the greatest drops in housing permits from their peak year, typify the general slowdown in the California housing market. Each area has lost 40 percent or more of the construction activity it once had.

Almost the entire West Coast is suffering, to some extent, from the housing slowdown. For example, Seattle, Portland, Sacramento and Honolulu appear among the greatest losers between 1990 and 1991.

The West Coast, however, is stronger than the East Coast. Most of the other cities that have dropped by the greatest absolute number or percentage from the peak year are on the East Coast. The large housing markets in the Southeast—from Atlanta to Tampa—have fallen significantly behind peak construction years in terms of number of units. However, it is the large size of these markets that puts them among the big losers. Construction in Atlanta is down 23 percent from its peak, about midway down the pack. The smaller New England and New Jersey metropolitan areas—hot growth markets during the heyday of Wall Street—are among the biggest losers on a percentage bases. These include Jersey City which has had essentially zero construction this year.

The slowdown on the East Coast is not limited to the Northeast. Single-family construction in Norfolk, Virginia is off 8,700 units from the peak—100 units worse than the decline in Tampa. There still is a lot of construction activity in Atlanta, but even so, it is off 8,000 units from the market's peak year.

The positive side of the regional picture of single-family construction is the mixture of revival in the energy cities, recovery in the Farm Belt and improvements in some industrial cities. In most cases, the best-performing areas in 1991 are those that suffered early and severely during the 1980s. Annualized permits thus far this year in Houston are 3,800 more than during all of 1990. Because of the uniqueness of the Houston recession, the column headings in Table 1 are inappropriate. For most cities, construction declined to a trough around 1982 and rose to a peak between 1986 and 1989. In Houston, however, construction peaked in 1982 and reached a trough in 1986. However, construction in Houston has not recovered to pre-oil-crash days. Estimated 1991 permit issuance of 12,900 units is well below the 27,000 units built during 1982.

Tulsa—another Energy Belt city—makes the list of those markets showing the greatest improvement from previous years' construction with 2,600 more units than during the best year during 1986-89. Other high-ranking cities are in the Industrial Belt (Louisville, Indianapolis, Milwaukee and Columbus) or in the Farm Belt (Omaha). Las Vegas, a strong housing market for the past few years, has continued to build during 1991. However, the economy of Las Vegas is slowing. This is a bad sign for an explosive growth area and suggests problems such as those experienced in Phoenix.

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Multifamily units

The multifamily construction market has experienced a much more severe decline than the single-family market, especially in comparison to pre-tax-reform days. In recent months, national multifamily construction has been running at rates of less than 200,000 units a year. This is down more than 70 percent from the 669,000 units actually started in 1985. On a regional basis, an area will make the 10 "best" list by only having lost 35 percent of its peak-year construction (See Figure 2). Only five markets on the list of 100 largest metropolitan areas are issuing multifamily permits at a rate that will surpass the best years of 1986 to 1989. Three of those MSAs—Gary, Indiana, Houston and Honolulu—are up from essentially no construction between 1986 and 1989, while the other two are up less than 5 percent. One quarter of the cities listed show annualized 1991 multifamily permits off more than 90 percent from their peak year.

Among the worst-performing regional markets in 1991 are the large apartment markets that reflect this overall trend. The extent of the decline in these markets cannot be overestimated. In Baton Rouge, Fort Worth, San Antonio, Oklahoma City and Tucson, annualized 1991 multifamily permits are down 99 percent from the peak year. In Los Angeles, apartment permit issuance has fallen from 54,000 to 13,100, while permits in Phoenix have fallen from 27,000 to less than 500. In 10 cities alone, annualized multifamily permits issued thus far in 1991 represent a drop of more than 200,000 units.

The slide is spreading even to those areas where growth had remained rapid well beyond the national peak. Apartment construction in Seattle is down by more than 10,000 units to 5,500 since 1990. This reflects the limited construction around Boeing factories, where employment growth has stopped.

Apartment construction in the next few years will consist of opportunistic developments and limited construction to meet natural demand growth. Construction of multifamily units for condominium ownership will remain weak except for those units that appeal to people who consciously choose to own something other than a house. Although we will continue to see gradual improvement in apartment operating figures, such as vacancy rates and rental increases, these positive signs will not translate into significant construction. New development will await a significantly looser financing climate and a weaker memory of the current commercial real estate crisis.

At this stage the economic recovery is both early and uncertain. Many industries and markets are still in a recession, while others await more positive news before engaging in significant new investment. All this is occurring in an era of upheaval for real estate and for certain housing finance providers, be they savings and loans, banks, insurance companies or Wall Street firms. While this unevenness and uncertainty continues, the housing recovery that has already begun will manifest itself only tentatively and unevenly across regional markets. **MB**

Robert Hopkins is a vice president in Salomon Brother's Real Estate Research Department. His fields of research include demographics, regional economics and commercial and residential real estate market trends.

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THE FHA FACTS

A detailed look at FHA insurance and claims data reveals much about the health of recent years' originations.

Brian Chappelle

Statistics recently made available by the Department of Housing and Urban Development on the performance of its FHA-insured portfolio reveal some encouraging signs for the mortgage lending industry. This article portrays some of the prominent results from the HUD study of FHA insurance and claims data, which covers the performance of Section 203(b) 30-year term mortgages originated from 1970 to 1991 as of June 30, 1991. From this data, several salient points can be observed:

- More than two-thirds of FHA's portfolio was originated in 1986 or later. Only 19 percent of the loans originated in the 1970s remain on FHA books.
- Loans originated in the 1986-to-1988 period are performing 100 percent better than the 1980-to-1985 books of business over similar periods of time and have claim rates comparable to the 1970s' books of business.
- To no one's surprise, FHA claims have been concentrated in the "oil-patch" states during the 1980s. Forty-eight percent of the claims HUD has paid on loans originated in fiscal years 1985 to 1986 came from Texas, Oklahoma, Louisiana, Colorado and Alaska. Fifty percent of all FHA loans originated in the state of Alaska in the first half of the 1980s have already resulted in claims for FHA.

Now we can observe the various ways this data breaks down and what impact it holds for the mortgage lending industry.

Performance of recent business

During the 1980s, FHA experienced a tremendous increase in activity. FHA insured 4.2 million mortgages from 1986 to 1990—more than it did in the previous 13 years from 1973 to 1985. It is not surprising, therefore, that of FHA's insurance written since 1970 that is still in force, 71 percent, representing 3,278,359 insured loans, was originated in 1986 or later. Table 1 provides specific data broken down into four-year origination periods on the seasoning of FHA's portfolio as of June 1991.

There is now growing concern that the FHA reforms have gone too far.

FHA's future solvency will be dependent on the performance of FHA origination activity since 1986. While it is desirable to have a more-seasoned portfolio from a risk management perspective, the concern about the concentration of recent originations is abated by the fact that FHA has tightened its underwriting policies since 1986 with over 30 different measures (e.g., buydown restrictions, elimination of risky programs and stricter compensating factors for borrowers above credit ratio guidelines) to reduce credit risk. In addition, many of the loans originated in the last half of 1986 and much of 1987 are refinances of loans originated in earlier years.

Claim performance improving

Chart 1 compares the cumulative claim rates for FHA loans originated from 1970 to 1988 for the first three

policy years. The chart documents the rise in claim rates for loans originated in the early 1980s. Claim rates for loans originated in 1986 to 1988 are lower and, in fact, are comparable to the levels of claim rates in the 1970s. Accordingly, while FHA's portfolio is unseasoned, the improved performance of recent originations is very encouraging.

In trying to pinpoint the causes of this performance over the last 20 years, Chart 2 shows a direct correlation between HUD's cumulative claim rates by year of insurance endorsement and interest rate movements. (There is a lag of several months, typically, between loan closing and insurance endorsement.) As mortgage interest rates rise, claim rates on mortgages originated in that particular time period rise similarly. While not available in this data, this relationship exists when there are changes within individual years. For example, when interest rates dropped sharply in the first half of 1986, FHA's claim rate on loans originated in the last half of 1986 was much lower than the claim rate on loans originated earlier that year. Also illustrative of this pattern is the tremendous peak in 1981, when FHA/VA interest rates were stretching to the 17 percent mark, and claim rates hit an all-time high of 8.1 percent for 1981 originations.

CHART 1

FHA Claim Rates for First Three Policy Years

1970-1988

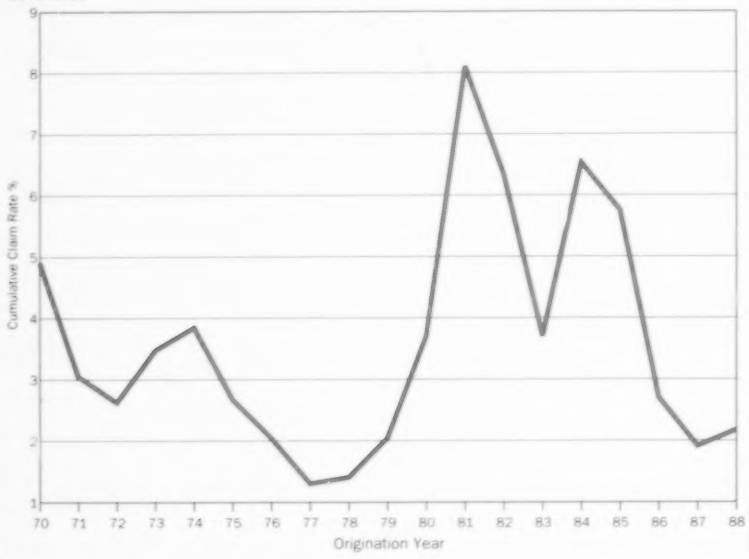
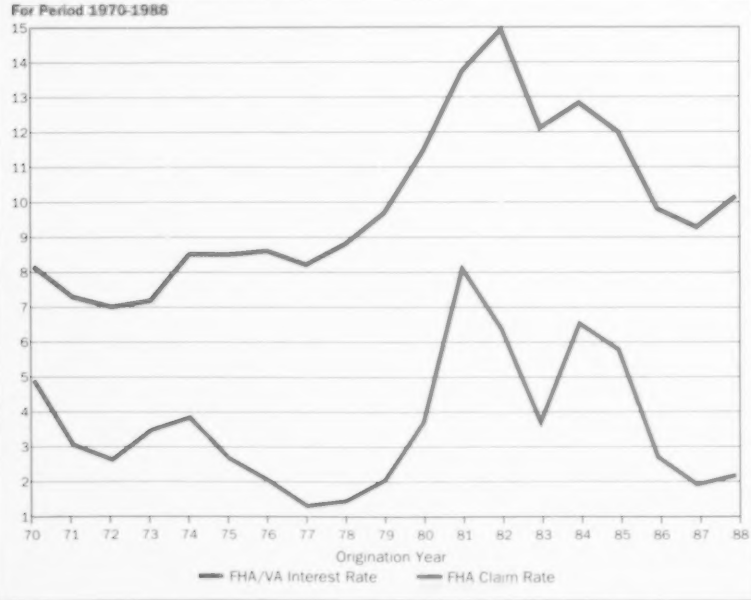


CHART 2

Interest Rate and FHA Claim Rate

For Period 1970-1988



Policy-year peaks

Chart 3 shows the number of claims that occurred by policy year for mortgages originated from 1981 to 1986. The increase in the number of claims for loans originated since 1983 stands out. This increase is tied to the growth in FHA activity that began in 1983 and continued steadily throughout the next several years.

Claims generally peaked in the third through fifth policy years and then declined in later years. Interestingly however, the 1979 and 1980 books of business are the exceptions to this rule. Chart 4 shows that in both years, there was a "second peak" for claims in the ninth policy year for 1979 originations and in the eighth policy year for 1980 originations. It is significant that 1987 was the year that both of these "second peaks" occurred.

Chart 5 provides claims by calendar year for loans originated from 1981 through 1986. In addition to the second peak for 1979 and 1980 origination years, the claims for the 1983 to 1985 books of business peaked in 1987. 1987 is also clearly a significant claim year for loans originated prior to 1980, as these loans also had a "second peak" in 1987.

Accordingly, it appears that the conditions existing in 1987, namely the re-

TABLE 1

Seasoning of FHA's Portfolio (Insurance-In-Force as of June 1991)

Years of Origination	Mortgages Outstanding	Percent Of Total
1971-75	315,593	7
1976-80	602,930	13
1981-85	410,316	9
1986-90	3,278,359	71

gional recession/depression in the Southwest, may have been the cause for the upturn in claims on these seasoned loans. These 1987 peaks appear, in fact, to be an anomaly, rather than evidence of a new trend whereby a second wave of risk would be expected to occur in later policy years. Based on the FHA data, it appears that the third through fifth policy years have the greatest credit risk.

FHA is, therefore, in effect becoming the insurer of last resort. Applications for FHA insurance have dropped 28 percent from April to August 1991.

The occurrence of these second peaks in 1987, for seasoned loans that were at least 7 years old and may be as much as 17 years old, also indicates that whatever problems existed in 1987 had little, if anything, to do with the mortgage origination process. For a borrower to make mortgage payments for seven years or more before going into default is indicative of structural problems in the local economy rather than problems with the mortgage lending process.

Geographic analysis

There has been considerable discussion in recent years about the impact of location on the occurrence of claims. There is little doubt that regional economic conditions contributed greatly to the second peaks of claim years for many FHA-insured loans in 1987. In this section, claim rates by state are analyzed for FHA's 1972-to-1988 books of business.

To begin this analysis, five states with the most serious claim problems for three different endorsement years were analyzed to provide a perspective on the impact of the location of claims on FHA's overall claim performance. 1977 had the lowest annual claim rate; 1981 had the highest annual claim rate and 1986 had the most claims paid.

Table 2 provides the claim rates of states with the most serious problems for that book of business in 1977, 1981 and 1986. Each year shown in the table is noteworthy for significant feature. The 1977 list is represented predominantly by "Rust Belt" states. The 1981 list demonstrates the impact of the 1981-1982 recession on the Northwest and the beginning of the problems in

CHART 3

FHA 203(b) Claims Paid
by Policy Year (1981-86 Originations)

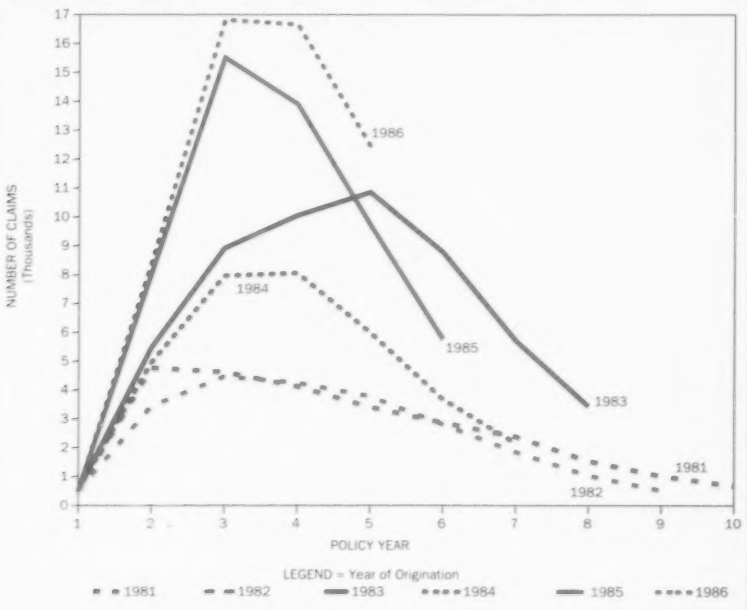
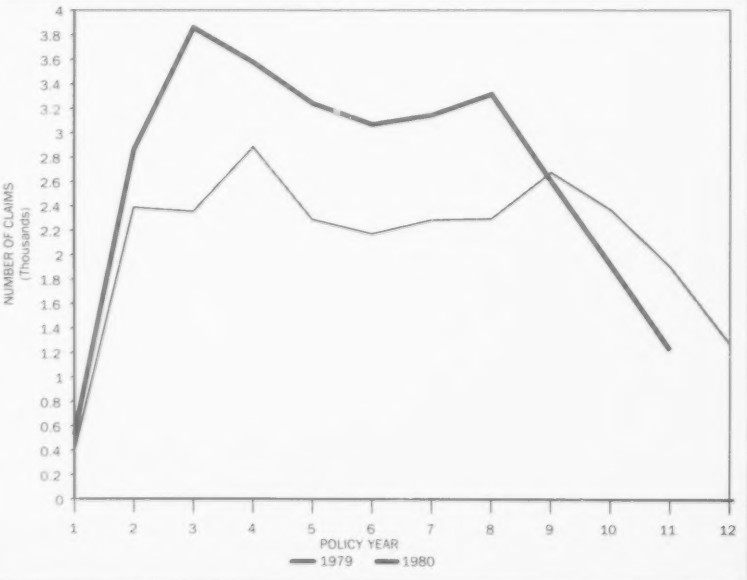


CHART 4

FHA 203(b) Claims Paid
By Policy Year (1979-1980 Origination)



the Southwest. The 1986 list shows the effect of the decline of states with oil-based economies.

What makes the 1986 data so devastating for FHA is the percentage of all of its claims that came from these five oil-patch states. Texas, Oklahoma, Louisiana, Colorado and Alaska comprised 19 percent of FHA's origination business and 48 percent of its claims during 1986. In the other three analyzed years, the percentage of all FHA claims that came from the five high-claim states was between 20 and 30 percent.

The impact of the problems in the oil-patch region is demonstrated in Chart 6. Throughout the entire period (1972 to 1988), the market share of the three states in the Southwest tied to the oil industry (Texas, Oklahoma and Louisiana) was between 12 and 18 percent of FHA's origination activity. Starting in 1978, there has been a steady increase in the percentage of FHA claims generated from these three states. The percentage peaked in 1986 when approximately one-third of all FHA claims on loans originated in 1986 came from these states.

The concentration is even more pronounced when the Houston area is analyzed separately. There are six field offices in Texas with Houston covering much of eastern Texas, and as much as 12 percent of all FHA claims on one year's book of business (1982) for the entire country came out of the Houston office.

The Denver office, which covers the entire state of Colorado, provides a similar picture for later years in the 1980s. As late as 1981, the Denver of-

The Price Waterhouse Turnaround

In the fiscal year 1989 audit, the accounting firm of Price Waterhouse made an adjustment to FHA's financial statement to slow down the earning of premium revenue to cover possible increases in defaults. The company explained its position as follows:

> This change results principally from applying more conservative assumptions with respect to house price appreciation, and thus provides a better method of matching premium revenues to losses from single-family loans.

Instead of earning revenue in the early years (policy years two through five), Price Waterhouse believes that HUD needs to defer income to cover possible defaults in the future.

On March 8, 1989, Price Waterhouse had stated in a GAO report that HUD was not recognizing premium income fast enough. In one year, Price Waterhouse shifted its position 180 degrees.

CHART 5

FHA 203(b) Claims
By Calendar Year of Claim

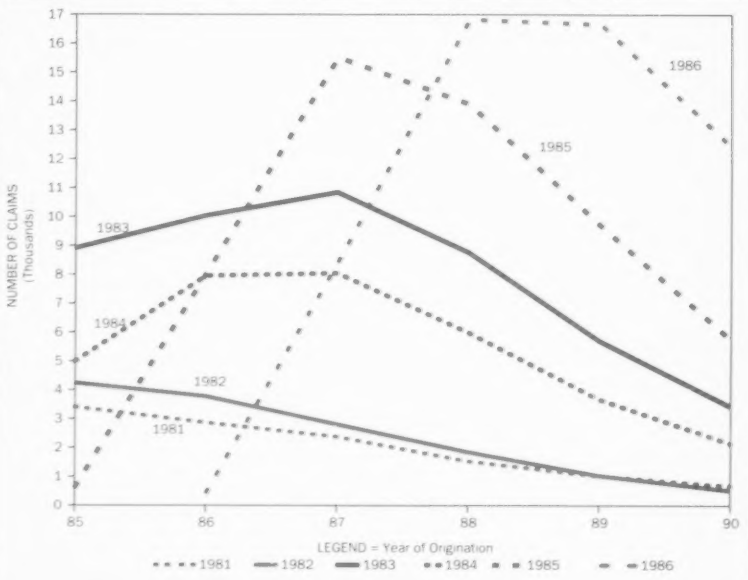
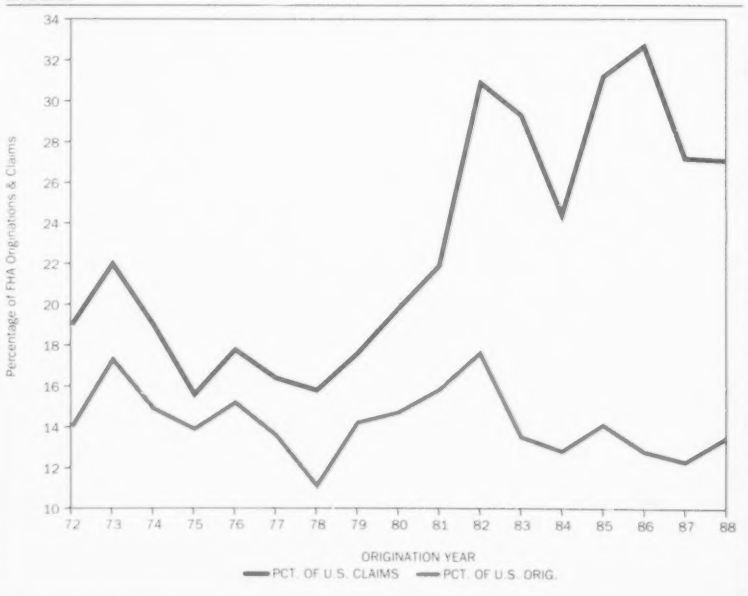


CHART 6

Percentage of FHA U.S. Total Insurance Written and Claims by Origination Year for Texas, Oklahoma & Louisiana
1972-1988



fice had a lower claim rate than the national average. By 1986, however, just about one of every seven FHA claims that resulted from a loan originated during that year came from Colorado.

During the 1980s, FHA claims were increasingly concentrated in those states relying heavily on the oil industry. This data documents the impact of the economic devastation on the housing industry. While loan-to-value (LTV) data was unavailable, it has shown in the past that low LTV loans were not exempted from this problem. In fact, for 1985 and 1986 originations, LTVs below 80 percent in the five oil states had higher claim rates than LTVs above 95 percent in the rest of the country.

This data may also explain the second peaks that occurred on seasoned loans. While data on claims by policy years is not available on a per-state basis, the economic problems and resulting property depreciation that beset the oil-patch states may be a significant factor in the number of seasoned loans that went into foreclosure during the period from 1985 to 1987.

What does this data mean for FHA's financial condition?

Last month, FHA released its fiscal-year 1990 financial statement, and it included positive signs that FHA's single-family program has turned the corner and is now in the midst of a complete recovery from the problems that plagued its operation in the 1980s. For the first time since 1987, the Mutual Mortgage Insurance Fund (MMIF), out of which the basic single-family program is operated, generated a net income of $66 million from its insurance operations. HUD acknowledged in the financial summary that this improvement was the result of a decline in single-family defaults and claims.

What is even more encouraging is that this improvement occurred even though an accounting adjustment made by Price Waterhouse in its 1989 audit, which slowed down the earning of income, remained in effect (See sidebar). As a result of that adjustment, even though FHA collected approximately $400 million more in premiums in fiscal year 1990 than it did in 1988 before the adjustment went into effect, it earned $325 million less in total income.

FHA released its fiscal-year 1990 financial statement, and it included positive signs that FHA's single-family program has turned the corner and is now in the midst of a complete recovery from the problems that plagued its operation in the 1980s.

The impact of this change is seen in the growth of the unearned premium account, which has risen from $3.8 billion in fiscal year 1988 to $5.6 billion in fiscal year 1990. This $1.8 billion nest egg is, in effect, a deferred compensation plan for the FHA program.

Another indication of FHA's improving financial strength is that there was a $638 million increase in "net cash operations." In fiscal year 1989 there had been only a $44 million increase and in fiscal year 1988 there had been a $322 million decrease in cash operations. The major items of the cash-flow statement are total premiums collected plus proceeds from the disposition of HUD properties minus claim settlement payments, premiums earned and the decline in loss reserves.

It is this last item that gives yet an-

TABLE 2

1977 Book of Business
High Claim Rates

State	Claims	Mortgages	Claim Rate
Pennsylvania	266	1,970	13.5
Illinois	301	2,300	13.1
Indiana	471	4,354	10.8
Ohio	1,024	9,840	10.4
Michigan	308	3,209	9.6
5 State Total	2,370	21,673	10.9
Rest of U.S.	7,148	220,860	3.2
U.S. Total	9,518	242,533	3.9
5 States As % of U.S. Total	25%	9%	

1981 Book of Business
High Claim Rates

State	Claims	Mortgages	Claim Rate
Oregon	409	966	42.3
Oklahoma	549	1,586	34.6
Illinois	1,345	4,054	33.2
Texas	4,672	16,256	28.7
Washington	862	3,084	27.9
5 State Total	7,837	25,937	30.2
Rest of U.S.	18,300	98,121	18.6
U.S. Total	26,137	124,058	21.1
5 States As % of U.S. Total	30%	21%	

1986 Book of Business
High Claim Rates

State	Claims	Mortgages	Claim Rate
Alaska	1,374	4,605	29.8
Texas	12,694	88,334	14.3
Oklahoma	3,761	18,059	20.8
Louisiana	1,893	15,077	12.6
Colorado	7,404	58,220	12.7
5 State Total	27,126	184,295	14.7
Rest of U.S.	28,899	763,672	3.7
U.S. Total	56,027	947,967	5.9
5 States As % of U.S. Total	48%	19%	

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other piece of good news from the fiscal year 1990 audit. Loan loss reserves were lowered $219.8 million in the fiscal year 1990 audit. This is the second straight year that FHA loss reserves were lowered. Because Price Waterhouse increased loan loss reserves by $1.2 billion in fiscal year 1988 there has now been a 58 percent ($694 million) decline from that figure.

The next chapter

It would have been nice to conclude this article by stating that FHA is on the road to complete recovery. As the saying goes, however, there is another chapter of this story yet to be written.

While HUD moved quickly to correct the abuses that occurred under Secretary Samuel Pierce with the enactment of the HUD Reform Act of 1989 and the implementation of numerous management improvements, there is now growing concern that the FHA reforms have gone too far. Specifically this pertains to the provisions of the 1990 housing bill that raise down payments and increase mortgage insurance premium costs for homebuyers. It is the latter point that raises questions about FHA's future solvency.

With the implementation of a one-half percent annual premium in addition to the 3.8 percent upfront MIP on loans closed July 1, 1991, HUD has increased the likelihood of adverse selection in the FHA program. Because of the increase cost, lower risk borrowers who were the backbone of the FHA program are now opting for private mortgage insurance because of lower cost and less red tape. FHA is, therefore, in effect becoming the insurer of last resort.

While definitive conclusions can not be reached for several more months, the initial returns are alarming. Applications for FHA insurance have dropped 28 percent from April to August 1991.

Based on the improvements discussed in this article, it is ironic that it now appears that FHA faces greater risk to its future solvency from the implementation of measures developed in the spirit of reform than it does from the performance of FHA's existing portfolio. **MB**

Brian Chappelle is staff vice president of residential finance and government agency relations at the Mortgage Bankers Association of America in Washington, D.C.

VITAL STATISTICS

KEY ECONOMIC INDICATORS AND INTEREST RATES

	CHANGES IN PAYROLL EMPLOYMENT (THOUSANDS)	UNEMPLOYMENT RATE (%)	CHANGES IN CONSUMER PRICES FROM YEAR AGO LEVELS (%)		MORTGAGE INTEREST RATES (%)		
			ALL ITEMS	ALL ITEMS LESS FOOD AND ENERGY	SECONDARY MARKET YIELD ON FHA NEW HOME MORTGAGES[1]	FHLMC ARMs	FHLMC FRMs
AUG-90	−109	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−47	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−131	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−221	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−140	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−203	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−258	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−258	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−166	6.6	4.9	5.1	9.61	7.38	9.49
MAY-91	151	6.9	5.0	5.1	9.62	7.22	9.47
JUN-91	−21	7.0	4.7	5.0	9.67	7.24	9.62
JUL-91	−51	6.8	4.4	4.8	9.65	7.23	9.58
Aug-91	NA	NA	NA	NA	NA	7.08	9.24

RATES ON SELECTED SECURITIES (%)

	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT				A-Rated Utility
			6-Month	1-Year	3-Year	10-Year	
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.91	6.07	5.71	6.24	7.23	8.04	9.46
MAY-91	5.78	5.92	5.61	6.13	7.12	8.07	9.45
JUN-91	5.90	6.11	5.75	6.36	7.39	8.28	9.53
JUL-91	5.82	6.05	5.70	6.31	7.38	8.27	9.55
AUG-91	5.66	5.72	5.39	5.78	6.80	7.90	9.25

CURRENT SECONDARY MARKET YIELDS (%)

	GNMA[2]	FNMA[2]	FHLMC[2]
AUG-90	9.80	9.75	9.75
SEP-90	9.86	9.79	9.73
OCT-90	9.84	9.80	9.69
NOV-90	9.63	9.66	9.54
DEC-90	9.22	9.27	9.16
JAN-91	9.17	9.24	9.12
FEB-91	8.81	8.86	8.77
MAR-91	9.00	9.03	8.93
APR-91	8.95	8.98	8.88
MAY-91	8.94	8.95	8.86
JUN-91	9.16	9.18	9.06
JUL-91	9.14	9.17	9.06
AUG-91	8.70	8.75	8.65

SPREADS
(Basis Points)

	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
AUG-90	105	100	100
SEP-90	97	90	84
OCT-90	112	108	97
NOV-90	124	127	115
DEC-90	114	119	108
JAN-91	108	115	103
FEB-91	96	101	92
MAR-91	89	92	82
APR-91	91	94	84
MAY-91	87	88	79
JUN-91	88	90	78
JUL-91	87	90	79
AUG-91	80	85	75

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
AUG-90	41,054	14,948	12,940	12,710	34	2,629	100	950	1,296	92	20,513	1,258	650	15,178	2,994
SEP-90	36,091	13,871	10,616	11,174	36	1,705	177	854	307	112	17,676	25	576	13,623	3,343
OCT-90	36,570	12,834	11,324	12,013	37	1,965	207	840	689	28	14,120	0	551	10,327	3,041
NOV-90	32,958	13,104	8,750	10,716	43	2,157	211	669	970	122	16,557	0	580	12,618	3,288
DEC-90	29,339	11,380	8,500	9,089	39	2,904	184	760	1,360	349	19,156	0	703	13,695	3,705
JAN-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
FEB-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
AUG-90	1,131	865	266	1,055	817	238	122	240	434	335	114	221	405	315
SEP-90	1,106	893	213	989	778	211	104	239	445	318	111	218	385	275
OCT-90	1,026	861	165	925	747	178	144	230	392	260	114	194	360	257
NOV-90	1,130	823	307	916	710	206	147	232	483	268	108	194	366	248
DEC-90	971	768	203	854	689	165	110	233	395	233	99	181	338	236
JAN-91	847	677	170	802	651	151	86	167	361	233	96	188	306	212
FEB-91	992	825	167	876	739	137	91	301	384	216	99	205	353	219
MAR-91	907	770	137	892	734	158	104	226	390	187	96	204	340	252
APR-91	977	833	144	913	787	126	93	236	395	253	102	210	361	240
MAY-91	983	867	116	966	801	165	114	216	367	286	105	221	379	261
JUN-91	1,032	888	144	999	834	165	145	246	389	252	115	227	391	266
JUL-91	1,070	942	128	1,005	836	169	106	235	448	281	116	235	400	254
AUG-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	414	117.9	9.3
FEB-91	3,160	94.0	488	119.9	8.0
MAR-91	3,220	98.2	495	122.5	7.5
APR-91	3,310	100.3	506	121.0	7.3
MAY-91	3,540	101.1	496	118.0	7.4
JUN-91	3,590	102.0	516	120.1	7.1
JUL-91	3,350	103.0	472	120.2	7.6
AUG-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
AUG-90	301.3	95.3	17.4	106.6
SEP-90	296.7	92.8	16.9	105.6
OCT-90	291.3	90.9	16.7	102.6
NOV-90	285.2	88.0	16.1	100.0
DEC-90	280.6	85.7	16.9	98.5
JAN-91	274.1	81.8	16.3	95.0
FEB-91	270.9	78.6	15.6	96.1
MAR-91	264.5	76.3	15.4	93.3
APR-91	267.9	76.4	14.4	97.5
MAY-91	261.1	79.9	13.9	88.6
JUN-91	260.1	83.4	13.4	83.9
JUL-91	262.5	87.2	12.5	83.8
AUG-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1]Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2]Securities for 0- to 30-day delivery.

[3]In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4]Savings & Loans and Mutual Savings Banks.

[5]In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.